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MONTERREY 00000089 001.2 OF 003

¶1. (U) Summary. Macroeconomics has become a hot topic among Monterrey businessmen as they try to determine the length and depth of the U.S. recession and its impact on Mexico. The Mexican economy is closely linked to the United States, and the U.S. recession has been transmitted to Mexico through declining exports, falling direct foreign investment, and other factors. Mexican economists generally expect the Mexican economy to remain weak through 2010, the Mexican peso will not recover, but inflation will moderate. They do not have high hopes for President Calderon's anti-recession package of infrastructure spending and reduced energy prices. End Summary.

Economists Forecast Weak Mexican Economy Until 2010

¶2. (U) In recent weeks Econoff has attended five different presentations by prominent economists to packed houses of business professionals. Although the current crisis is not as bad as the economic slump of 1995, since government finances and the banking system are sound, there has been a substantial impact. The U.S. recession has particularly affected the Monterrey area, which focuses on exports of bulky consumer durables, such as cars and electronics, to the United States (see reftel A for the effect on employment throughout Mexico).

¶3. (U) Due to the close economic ties between the U.S. and Mexico, particularly in areas such as trade, investment and remittances, the Mexican economy is likely to follow the lead of the United States. Former Mexican Central Bank Deputy Governor Everardo Elizondo and American Chamber of Commerce economist Deborah Riner both noted that Mexican economic growth is closely correlated with the U.S. Industrial Production index. Just as the U.S. industrial production index is falling sharply, the Mexican GDP is, after a lag, following suit. Riner commented that the U.S. economy sets the parameters for Mexican growth. Elizondo stated that the Mexican economy will show negative growth at least in the last quarter of 2008 and in the first quarter of 2009, and internal Mexican demand will not recover until 2010. Riner commented that under her optimist scenario Mexican GDP would fall 1% in 2009, and slowly grow at 1.7% in ¶2010. Several businessmen attending the Riner presentation thought that these projections were far too rosy.

¶4. (U) Elizondo and Riner detailed several reasons for the continued weakness of the Mexican economy. Since Mexico exports almost 80% of its goods to the U.S., obviously a weak U.S. economy adversely affects Mexico. Riner also expects remittances to decline but not to drop drastically, and she projects that foreign direct investment in Mexico will fall from $25 billion USD in 2007 to $19 Billion in 2008, dropping to $17.5 billion in 2009 until rebounding slightly to $19 billion in 2010. Elizondo emphasized that Mexican consumer spending accounts for approximately 70% of the GDP, and he expects that tight credit and low consumer confidence will hold down consumer spending in the near term. Moreover, Mexican consumers have lost spending power, since wages rose 4.5%, while inflation increased by 6% in 2008.

¶5. (U) The Mexican peso has depreciated 40% in value against the U.S. dollar, and the economists do not expect the peso to recover (see reftel B). Following the trend of other currencies, the Mexican peso has devalued sharply since the second half of 2008 due to the global flight to the safety of U.S. greenbacks, falling Mexican industrial and petroleum exports, small declines in remittances, an outflow of portfolio investments, and the demand by Mexican corporations for dollars to cover substantial losses in derivatives. Elizondo, Riner, Cemex economist Gerardo Cruz Vasconcelos, and Actinver Investment House economist Francisco Suarez all project that the Mexican peso will not recover its value through 2010. Moreover, there are some worrisome long term trends. In the summer of 2008 the Government of Mexico cleverly hedged and ensured that Mexico will receive $70 per barrel of oil through 2009, far above the current world price of oil. However, starting in 2010 Mexico will only receive the market price, and its oil production is also declining significantly (see reftel C). Lower manufacturing exports, foreign direct investment and lower

remittances will reinforce the trend towards a weaker peso. Riner, for example, projects higher current account deficits of $10 billion in 2007 (1.0% of GDP), $16 billion in 2008 (1.5% of GDP), $25 billion in 2009 (2.8% of GDP), and $42 billion in 2010 (4.7% of GDP).

¶6. (U) Several economists project that inflation, which reached 6.5% in 2008, far above the Central Bank's target of 3%, would decline due to weakened demand. Riner forecasts that annual inflation will fall to 4.37% in 2009 and 3.66% in 2010. However, several business people were skeptical of this favorable scenario. Mexico imports many goods, including foodstuffs, from the United States, and the depreciation of the Mexican peso will push the price of imported goods sharply higher. Although Elizondo thought that weak demand would restrain prices in the short run, if a store's inputs increase 40% in price, they cannot continue to maintain their price levels for long. In addition, many goods made in Mexico contain U.S. components, which will also push these prices higher.

¶7. (U) Another drag on the economy could be the increasing IETU tax rates. The IETU, introduced by President Calderon in 2008 to increase tax collection rates, will increase its rate from 16.5% in 2008 to 17% in 2009 and up to 17.5% in 2010. Mexican taxpayers must calculate their tax both for the ISR income tax (with higher tax rates and many more deductions) and the IETU (focusing on sales with many fewer deductions) and pay the higher of the two. Cruz Vasconcelos complains that since businesses cannot deduct business losses the IETU tax will increase tax collection during a recession, further dampening demand and the economy. Note. Businessmen have complained about the IETU since its inception, and Econoff has heard complaints, but no rigorous economic analysis, demonstrating how

the IETU taxes would damage the economy. End Note.

¶8. (SBU) The depreciation of the Mexican peso should boost exports and international competitiveness by companies utilizing substantial Mexican content. For instance, a Mexican company selling services could do well, since most of its costs are paid to Mexican professional in pesos but its income is in U.S. dollars. One such example is the Monterrey software based development firm Dextratech, whose principal expense, salaries, in denominated in pesos while its sales to U.S. clients are denominated in appreciated dollars. Dextratech's overall volume of sales has declined slightly, but profits have risen due to the rising exchange rate. However, this phenomenon is of limited benefit to many Mexican maquilas, since they use U.S. inputs for over 70% of the value of their exports, so the declining peso will be of marginal assistance. In addition, some countercyclical industries are also doing well. For example, the U.S. company Autozone, which supplies auto parts to consumers, has increased sales as people repair their old cars rather than purchase a new one.

Criticism of Calderon's Program to Reactivate the Economy

¶9. (U) The economists all agreed that President Calderon's plan to reactivate the economy is too small to do the job. President Calderon has proposed several plans to stimulate internal demand, including spending on infrastructure, programs to retain jobs, and freezing gasoline prices (see reftel D). Riner pointed out that Calderon's entire program represents 1% of Mexico's GDP, insufficient in her view to restart demand. Riner also noted that the GOM is very slow to spend money on infrastructure projects, a key component of Calderon's plan. Cemex's Cruz Vasconcellos argued that Calderon's infrastructure spending will only balance out declines in the construction industry, not provide fresh stimulus to the economy. Although Cruz Vasconcellos projects that Calderon's program will increase infrastructure spending from 472 billion pesos in 2008 to 589 billion pesos in 2009, this will be more than counterbalanced by falling construction of non-residential buildings. Indeed, Cruz Vasconcellos projects that total spending by the construction industry on residential, non-residential and infrastructure projects, will fall from 1,593 billion pesos in 2008 to 1,554 billion pesos in 2009.

¶10. (SBU) Comment. Econoff has found that Northern Mexican businessmen are keenly interested in President Obama's economy recovery package, which they see as their potential salvation. They are not impressed with their own government's efforts, which seem to focus on denying the economic difficulties of 2009, rather than designing a program large enough to reactivate the Mexican economy. End Comment.
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